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In the

Supreme Court of the United States

OCTOBER TERM, 1957

No. 108

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

v.

JOHN WRATHER, *et al.*,
Respondents.

On Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit

BRIEF FOR RESPONDENTS, JOHN WRATHER, et al.

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BRIEF FOR RESPONDENTS, JOHN WRATHER, et al.

OPINIONS BELOW

The memorandum findings of fact and opinion of the Tax Court in the *Wrather* case (R. 211-213) are not officially reported. The opinion of the Court of Appeals (R. 237-238) is reported at *241 F. 2d 69*.

JURISDICTION

The judgment of the Court of Appeals was entered on February 1, 1957. (R. 238-239) The petition for a Writ of Certiorari was filed April 17, 1957, and was granted June 3, 1957. This Court has jurisdiction under *28 U. S. C., Section 1254.*

STATUTES INVOLVED

The pertinent provisions of the Internal Revenue Code of 1939, which are Section 117(a)(1) and Section 117(j), are set forth in the Appendix, *infra*, pp. 17-19.

QUESTIONS PRESENTED

The question involved in this case is whether both Courts below erred in holding that the taxpayer John Wrather's share of the proceeds received from the sale of oil payments by the partnership of which he was a member was long-term capital gain under Section 117 of the Internal Revenue Code of 1939 rather than ordinary income subject to depletion.

STATEMENT

The basic facts were all stipulated (See R. 207-210, 214-236) except that there is some pertinent testimony. (See R. 206-207).

During the year 1948, which is the taxable year here in issue the taxpayer, John Wrather, was a member of a partnership known as the George & Wrather Drilling Com-

pany. (R. 208) The partnership was in the oil business, its principal activity being drilling for and producing oil and gas from properties owned by the partnership. (R. 207) Among other properties, the partnership owned oil and gas leasehold or working interests in two leases known as the Brown Lease on land located in Illinois and the Kieffer "A" Lease on land located in Indiana. The partnership owned an undivided 7/24ths interest in the Brown Lease and an undivided 5/16ths in the Kieffer "A" Lease. (R. 208, 209) Both the Kieffer "A" and Brown Leases were held by the partnership for the development and production of oil, gas and other minerals therefrom. (R. 210) Both leases were productive and had produced income for the partnership prior to 1948. (R. 208, 209)

By a conveyance dated June 19, 1948, the partners and their wives, as individuals and for the partnership, sold and conveyed to the Indiana Farm Bureau Cooperative Association, Inc., hereinafter referred to as the Cooperative, an oil payment in the amount of $130,000.00 to be paid out of 9/10 of 7/24 of 7/8 of the oil produced and saved from the Brown Lease. (R. 208) In consideration for this oil payment assignment the Cooperative paid the partnership $125,000.00 in cash on or about the date of the assignment. (R. 208)

By another conveyance dated June 19, 1948, the partners and their wives, as individuals and for the partnership, sold and conveyed to the Cooperative an oil payment in the amount of $155,000.00, to be paid out of 9/10 of 5/16 of 7/8 of all the oil produced and saved from the Kieffer

"A" Lease. (R. 209) On August 16, 1948, the partners and their wives conveyed to the Cooperative another $12,500.00 oil payment payable out of the same fraction of the Kieffer "A" Lease. (R. 209) In consideration for these oil payments from the Kieffer "A" Lease, the Cooperative paid the partnership $162,500.00 cash on or about the date of the assignments. (R. 209)

In June 1948 the Cooperative received its first proceeds attributable to the oil payments from both leases. By January 1952, the Cooperative had received $130,000.00 from the Brown Lease and by June 1953, $167,500.00 from the Kieffer "A" Lease. (R. 210) The reasonable pay-out time of the three oil payments was calculated at the time of the assignments to be from four to six years. (210)

In their joint income tax returns for 1948, taxpayers reported taxpayer John Wrather's one-half (½) share of the proceeds in the amount of $143,750.00 as long-term capital gain. This controversy arises out of a determination by the Commissioner that the sale proceeds are taxable as ordinary income subject to depletion. (See R. 211)

ARGUMENT

The *Wrather* case is one of five cases all involving the same basic issue. The other cases are *Lake*, *O'Conner*, *Fleming* and *Weed*. The Government has filed a single brief in all five cases but since there are different counsel for each of the taxpayers, a single brief for the taxpayers presented obvious problems too difficult to overcome in the short time allowed. Nevertheless, the principle affirmative arguments of the taxpayers are substantially the same and the

briefs for the taxpayers in the *Lake* and *O'Conner* cases so fully and persuasively submit the arguments for the taxpayers that it is felt that a lengthy repetition thereof in this brief would unduly burden the Court.

Accordingly, this brief will be limited to a summarization or outline of the basic arguments with specific comments on certain matters peculiar to the *Wrather* case.

The position of the taxpayer is that the oil payment sales here in controversy were bona fide sales of a substantial property interest, the gain from which is taxable as long-term capital gain under *Section 117 of the 1939 Internal Revenue Code*.

I.

FEDERAL TAX CHARACTERISTICS OF OIL PAYMENTS

A. Sources of Oil Payments—

Oil Payments are property interests in oil in place in the ground and are not new or novel to the oil industry since they have played a vital part in the development of the industry from the beginning. An oil payment may be created by transferring an interest in an oil and gas property and "reserving" the oil payment, or an oil payment may be "carved-out" from a quantitatively larger interest and transferred to another. In either case, the tax characteristics of the oil payment are the same. The Government's attack in these cases suffers from fundamental error because it ignores the established nature of oil payments for Federal tax purposes.

B. Economic Interest—

An owner of an interest in oil and gas in place (i.e., in the ground) has an "economic interest" in the oil and gas in place entitling him to an allowance for depletion upon proceeds derived from production and sale of the oil.[1] The requisite economic interest is possessed by owners of oil and gas leasehold or working interests, royalties, overriding royalties and *oil payments*. The manner in which the interest is acquired does not affect the presence of an economic interest in the owner.

An economic interest in oil in place exists when the owner must look solely to the oil in place to realize upon his capital investment therein.[2] Congress has provided an allowance for depletion to replace the owners capital investment in the oil in place which is consumed by the gradual extraction and sale of the oil in the day to day producing operations.[3] The assignees in these cases acquired an economic interest in the oil in place and are entitled to the depletion allowance.[4]

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[1] *Palmer v. Bender, 287 U. S. 551; Thomas v. Perkins, 301 U. S. 655; Anderson v. Helvering, 310 U. S. 404; Burton-Sutton Oil Company v. Commissioner, 328 U. S. 25; Commissioner v. Southwest Exploration Company, 350 U. S. 308.*

[2] *Anderson v. Helvering, 310 U. S. 404.*

[3] *Burnet v. Harmel, 287 U. S. 103.*

[4] The Government urges that the "form" of the conveyances in the *Wrather* case (See Exs. G-7, I-9, and J-10, R. 225-227, 230-236) reduce the interests conveyed to nothing more than a right to receive cash payments. The form used can be misleading until it is realized that Wrathers assignee under the law received a conveyance of an undivided interest in the oil and gas in the ground and acquired all rights of ownership in and to it. This follows from the nature of the conveyance and is not dependent or mere form. Moreover, in *Anderson v. Helvering, supra*, this Court, in discussing the earlier decision in *Thomas v. Perkins, supra*, states: "The decision did not turn upon the particular instrument involved, or upon the formalities of the conveyancer's art, but rested upon the practical consequences of the provision for [oil] payments of that type."

C. Owner May Produce the Oil or Sell His Interest—

There are two ways by which the owner of oil and gas properties may realize upon his capital investment in the oil and gas in place:

1. The oil may be extracted and sold thereby producing ordinary income subject to depletion; or

2. All or some part of the interest in the oil in place may be sold thereby producing capital gains which are not subject to the allowance for depletion.

D. Oil Payments Are Real Property—

Oil and gas leasehold or working interests, royalties, overriding royalties and "retained" oil payments are everywhere regarded as real property. It does not appear that the Government would contend otherwise. The manner of creation or acquisition does not transmute real property into personal property. An oil payment "carved-out" and assigned out of any of the aforementioned mineral properties of necessity remains of the same character, namely, real property. State and local law regards oil payments as real property in that they are subject to real estate ad valorum taxes, they descend to heirs as realty and they are subject to the Statute of Frauds and to real property recordation requirements.

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[1] *People, ex rel. Carroll v. Bell, 85 N. E. 593, 237 Ill. 332; Transcontinental Oil Company v. Emerson, 131 N. E. 645, 298 Ill. 394, 16 ALR 507; Sheffield v. Hogg, 124 Tex. 290, 77 S. W. 2d 1020; Shepard v. Standlind O & G Company, 125 S. W. 2d 290; Tennant v. Dunn, 130 Tex. 285, 110 S. W. 2d 53.* See also: Summer's "Law of Oil and Gas" (1954), pp. 422, et seq.

II.

BONA FIDE SALES OF OIL PAYMENTS SUBJECT TO CAPITAL GAINS TREATMENT

A. Sale of Real Property Used in Trade or Business—

Clearly the oil payment sales here involved were sales of property and fall under the literal terms of the capital gains provisions of Section 117 of the Internal Revenue Code of 1939.[6] Moreover, these sales are not within the exclusions under Section 117 except that they were sales of "real property used in the trade or business" and thus are excluded from the definition of capital assets under Section 117(a) but they come within and are allowed capital gains treatment under Section 117(j).

B. Mineral Properties Both "Fruit" and "Tree"—

Oil and gas in place represents at one and the same time the owner's capital investment property and is also future income to be realized by extraction and sale of the oil. With this dual personality, it is both the "fruit" and the "tree." Consequently, ordinary concepts of taxability do not apply to oil and gas properties. To argue that what was sold in these cases was future income only, ignores completely the capital investment feature of the taxpayers' property. While the oil in place may represent future income, it must be extracted and sold to produce ordinary depletable income. If the capital investment property itself or a part thereof is sold, as was done here, capital gain results and depletion is not allowable.

[6]See Appendix, *infra*.

C. Relief From Excessive Tax Burdens on Gains Resulting From Conversion of Capital Investments—

It is difficult to conceive of a more striking example of conversion of capital investment property than in the sale of these oil payments. In the instant case the purchasers waited 4 to 6 years before realizing fully on their capital investment. One of the oil payment transfers involved in these cases had a 10 to 12 year pay-out.[7] Realizing the dual nature of these mineral properties as being both capital investment property (or tree) and future income (or fruit), capital gain treatment is even more obviously called for.

It is not believed that Congress intended to cause 12 years of so-called "future income" to be bunched into a simple accounting period to be taxed at excessive surtax rates. On the contrary, Congress intended to relieve this burden by enacting the capital gains provisions. The oil payment sales involved here were isolated transactions and were not in any sense similar to the day to day business operations of an oil producer or of a manufacturing operation.[8]

[7] (See R. 184), *Commissioner v. Wm. Fleming, et al.*

[8] *Burnet v. Harmel, 287 U. S. 103,* and *Corn Products Company v. Commissioner, 350 U. S. 46,* are inapposite here. The granting of an oil and gas lease was involved in the *Harmel* case. The Court decided that the transaction was not a "sale" for tax purposes and, therefore, the capital gains provisions did not apply. In *Corn Products,* the taxpayer engaged in hedging transaction in corn futures. It was found unequivocally that the transactions involved were an integral part of the taxpayer's business designed to protect its manufacturing operations. Such transactions are inherently not capital gains transactions. They are the regular, daily business dealings of the taxpayer and are not the isolated, non-curring conversion of capital assets represented by the sales in this case.

III.

ASSIGNMENT OF INCOME RULE IS INAPPLICABLE

A. Unjustified Extension of Rule—

Taxpayers do not quarrel with the tax results arising out of a proper application of the assignment of income rule. But the Government's attack here requires an unwarranted extension of that rule into virgin territory. The facts in these cases present business transactions which are in no sense donative assignments of income which have for their principal purpose a re-arrangement within a family group of family income and having no real economic consequences other than tax savings.[9] This was not an assignment of derivative income such as future rents or future interest. In fact, except to the extent mentioned in describing the dual nature of mineral properties, oil payments are not income at all.

B. Not Mere Diversion of Income—

The assignment of income rule contemplates that there was no *sale* of property. More accurately it might be said that the application of the rule requires that the sale be ignored and treated as if it were a mere diversion of pure income to another. Of course, there are transactions involving transfer of oil payments which may be so lacking in substance as to be no more than a mere diversion of

[9]Cf., *Helvering v. Horst*, 311 U. S. 112; *Harrison v. Schaffner*, 312 U. S. 579; and *Helvering v. Clifford*, 309 U. S. 331.

income to a third party.[10] The facts in the instant case clearly negative any lack of substance in the sale of these oil payments. It follows then, that the assignment of income rule is not applicable to these cases.

IV.

LEGISLATION—CONGRESSIONAL, ADMINISTRATIVE, JUDICIAL

A. Congressional Legislation—

Congress enacted the original capital gain provisions in 1921, clearly intending that they should apply to the sale of mineral properties.[11] The trend over these 37 years has been to liberalize the coverage of the capital gains provisions. To this end, Congress has gradually reduced the required holding period of a capital asset from two years to six months in order to qualify for long-term capital gain. Section 117(j), under which the instant case falls, was added in 1942 and other liberalizing amendments have been made from time to time.

If there is to be denial of capital gain treatment in cases of oil payment sales such as these, it is plain that Congressional action is required.

B. Administrative Legislation—

From 1921 to 1946, the Treasury Department recognized that sales of carved-out oil payments were subject to the

[10] E. g. Rudco Oil and Gas Company v. U. S., 82 Fed. Supp. 746 (Ct. Cls., 1949) where a corporation assigned an oil payment to it stockholders to satisfy a cash dividend.

[11] See the Report of the Ways and Means Committee, 67th Cong., 1st Sess., H. Rept., 350, in connection with the Revenue Act of 1921.

capital gains provisions.[12] But in 1946 by administrative fiat, the Treasury Department attempted to change the law. It was claimed that the anticipation of income rule applied to sales of carved-out oil payments of short duration; e. g., those which took one to two years to pay-out.[13] This was done without either congressional or judicial sanction. Not satisfied however, in 1950 the Treasury Department adopted the extreme view being urged on this Court in these cases.[14] That is to say, the Government would have this Court hold that the sale for cash of *every* carved-out oil payment, without regard to whether the pay-out is three months or 13 years, produces immediate ordinary income subject to depletion. After extensive review by the lower Courts that proposition has not been accepted by a single judicial body.[15]

At the time the oil payments were sold in the instant case, this taxpayer could not know that these transactions would be attacked as assignments of income. On the contrary, the sales were made in 1948 at a time the Treasury's published position allowed capital gains treatment.[16] The

[12]Many private rulings to this effect were issued. *Cf. R. E., Nail, 27 B. T. A. 33 (1932), Acq. XII-1 C. B. 3; Majestic Oil Corporation, 42 B. T. A. 659 (1940), Acq. 1940-2 C. B. 5; Ortiz Oil Company, 37 B. T. A. 656, Aff'd. (5 Cir., 1939), 102 F. 2d 508, cert. den., 308 U. S. 566.*

[13]G. C. M. 24849, 1946-1 C. B. 66.

[14]I. T. 4003, 1950-1 C. B. 10.

[15]No Court has yet held that the cash consideration for the sale is all taxable in the year of sale as ordinary income, thus "bunching" the income into high surtax brackets.

[16]The duration of the oil payments in the *Wrather* case were 4 to 6 years which was 2 to 3 times longer than those condemned in G. C. M. 24849, 1946-1 C. B. 66.

litigation in this case arises out of a retroactive application of administrative legislation which must not prevail.

C. Judicial Legislation—

In seeking the Supreme Court's endorsement of its position in this case, the Government is asking the Court to usurp the constitutional authority vested in Congress to amend the income tax law. This Court should not do so. The representatives of the Internal Revenue Service are highly successful tax collectors without need for this Court to become Treasury's watch dog. In short, reversal of these cases would be unwarranted judicial legislation.

D. Device Cases—

This does not mean that the Court must stand idly by while taxpayers conceive ingenious methods for avoiding their taxes where these devices lack real substance. But even in the area of carved-out oil payments, the lower Courts have demonstrated an unwillingness to permit "device" cases to succeed.[17] The instant case is not merely an attempt to convert ordinary income into capital gain. In fact, the transaction was in no part a tax avoidance scheme. On the contrary, the sales of these oil payments were bona fide sales of real property used in taxpayer's business.

[17] *Cf., Commissioner v. Hawn (5 Cir., 1956), 231 F. 2d 340.* While the Court in *Commissioner v. Slagter (7 Cir., 1956), 238 F. 2d 901,* appears to accept the Government's extreme contention, it did not in fact do so. The facts in the *Slagter* case show that the purchaser of the oil payments (Ashland Refining Company) was the purchaser of *all* the oil being run from the mineral deposits involved. The Court held, therefore, that the transaction was in the nature of a "loan" and not a sale. It was held that the sellers were taxable on the oil as it was run to the Ashland Refining Company. This is a far cry from what the Government contended there or contends here.

V.

THESE OIL PAYMENTS CONVEYED SUBSTANTIAL PROPERTY INTERESTS

The Government urges alternatively that the oil payments conveyed in these cases are insubstantial, temporary and of short duration. Although, an ample showing has already been made that the transfers were of substantial property interest it will now be shown specifically that the facts in the *Wrather* case refute the Government's contention. The interest owned by the George & Wrather Drilling Company in the Brown Lease was a 7 24ths working interest, and that owned in the Kieffer "A" Lease was a 5/16ths working interest. The oil payments conveyed to the purchaser 9 10ths of the interest owned by the partnership. The 1 10th which was retained was no doubt, only barely sufficient to defray the partnership's share of the lifting costs. It took 4 years in the case of the Brown Lease and 5 years and 3 months in the case of the Kieffer "A" Lease to produce enough oil from the property transferred to satisfy the terms of the conveyance. Whats more it can be shown that the quantity of oil necessary to liquidate the oil payments was approximately 82% of the total estimated oil reserves attributable to the interest owned by the partnership in the Brown Lease and 75% in the case of the Kieffer "A" Lease. This is not the picture of a transfer of property which lacks substantiality. The oil payments conveyed a substantial and durable property interest.

CONCLUSION

The instant case and the other cases involved in this appeal must be decided on their own facts. That is to say, this Court should not strike down the decisions of the lower Courts in the present case in an effort to establish a rule deemed necessary to protect the integrity of the capital gains provisions from a transaction which is no more than a device, is not in substance a sale, or otherwise is lacking in substantiality. The oil payments sold in the *Wrather* case were sales of substantial and durable property interests—they are sales of real property used in the taxpayers' business and should be subject to capital gains treatment.

It is submitted that the decision of the Court below in the *Wrather* case should be affirmed.

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APPENDIX

SEC. 117. CAPITAL GAINS AND LOSSES.

(a) DEFINITIONS—As used in this chapter—

(1) CAPITAL ASSETS—The term "capital assets" means property held by the taxpayer (whether or not connected with his trade or business), but does not include—

(A) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or properly held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business;

(B) property, used in his trade or business, of a character which is subject to the allowance for depreciation provided in section 23(l), or real property used in his trade or business;

(C) a copyright; a literary, musical, or artistic composition; or similar property; held by:

(i) a taxpayer whose personal efforts created such property, or

(ii) a taxpayer in whose hands the basis of such property is determined, for the purpose of determining gain from a sale or exchange, in whole or in part by reference to the basis of such property in the hands of the person whose personal efforts created such property; or

(D) an obligation of the United States or any of its possessions, or of a State or Territory, or any political subdivision thereof, or of the District of Columbia, issued on or after March 1, 1941, on a discount

basis and payable without interest at a fixed maturity date not exceeding one year from the date of issue.

* * * * *

(j) Gains and Losses From Involuntary Conversion and From The Sale or Exchange of Certain Property Used in the Trade or Business.—

(1) DEFINITION OF PROPERTY USED IN THE TRADE OR BUSINESS. For the purpose of this subsection, the term, "property used in the trade or business" means property used in the trade or business of a character which is subject to the allowance for depreciation provided in section 23 (l), held for more than 6 months, and real property used in the trade or business, held for more than 6 months which is not (A) property of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year, or (b) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, or (C) a copyright, a literary, musical, or artistic composition, or similar property, held by a taxpayer described in subsection (a) (1) (C). Such term also includes timber or coal with respect to which subsection (k) (1) or (2) is applicable and unharvested crops to which paragraph (3) is applicable. Such term also includes livestock, regardless of age, held by the taxpayer for draft, breeding, or dairy purposes, and held by him for 12 months or more from the date of acquisition. Such terms does not include poultry.

(2) GENERAL RULE—If, during the taxable year, the recognized gains upon sales or exchanges of property used in the trade or business, plus the recognized gains from the compulsory or involuntary conversion (as a result of destruction in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnnation of the threat or imminence thereof) of property used in the trade or business and capital assets held for more than 6 months into other property or money, exceed the recognized losses from such sales, exchanges, and conversions, such gains and losses shall be considered as gains and losses from sales or exchanges of capital assets held for more than 6 months. If such gains do not exceed such losses, such gains and losses shall not be considered as gains and losses from sales or exchanges of capital assets. For the purposes of this paragraph:

(A) In determining under this paragraph whether gains exceed losses, the gains described therein shall be included only if and to the extent taken into account in computing gross income and the losses described therein shall be included only if and to the extent taken into account in computing net income, except that subsection (d) shall not apply.

(B) Losses upon the destruction, in whole or in part, theft or seizure, or requisition or condemnation of property used in the trade or business or capital essets held for more than 6 months shall be considered losses from a compulsory or involuntary conversion.

(3) SALE OF LAND WITH UNHARVESTED CROP.—In the case of an unharvested crop on land used in the trade or business and held for more than 6 months, if the

crop and the land are sold or exchanged [for compulsorily or involuntarily converted as described in paragraph (2)] at the same time and to the same person, the crop shall be considered as "property used in the trade or business."